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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

UIL: 4941.04-00

Contact Person:

ID Number:

Telephone Number:

Employer Identification Number:

Legend

A=

X=

Dear Sir or Madam:

This is in response to a ruling request submitted on your behalf by your authorized representatives. You are seeking rulings on the effects under section Chapter 42 of the Internal Revenue Code of a proposed transaction as more fully set forth below.

You have represented that X is a corporation created by A. X has been recognized as exempt from federal income tax under section 501(c)(3) of the Code and as a private foundation described in section 509(a).

The members of X are the lineal descendants by blood of A. The members elect the Board of Trustees of X which has traditionally consisted of both members of X and non-member trustees and which has met traditionally three times per year including a meeting which immediately follows the annual meeting of the members.

X is principally a grant-making foundation which uses the income from its portfolio of securities for grants. X's Board of Trustees has traditionally tried to select program areas for grants and to award a substantial portion of the available grant funds for grants which have a salutary impact on national or international problems or public policy issues. X's staff in the grant area has been responsible for reviewing and submitting to the Board of Trustees potential areas for consideration and for attracting and reviewing the applications of qualified grantees within the approved program areas and for submitting the best applications for grants to the Board of Trustees for consideration. The staff has also been responsible for documenting and administering approved grants to insure compliance with the terms on which such grants were awarded and the [Internal Revenue] Code.

In recent years differences of opinion have arisen among the members as to the manner in which X should award grants in furtherance of its charitable purposes. Some members disagree with the program areas selected by the Board of Trustees and would select other program areas, but would agree that X should continue to devote a significant portion of the funds available for grants to program areas where there is an opportunity to have significant impact on national or international problems or public policy issues.

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Other members would prefer that grants be awarded to charities that function in their local communities or to other charities which conform more closely to their own philanthropic views. Although there has been general dissatisfaction with the grant-making policies and a consensus has developed that the members should have more influence over grant-making, no consensus has developed as to a replacement grant-making program.

Differences of opinion among members in the grant-making area have led to disagreements among the members as to corporate governance issues, including the functioning of the Investment Committee which retains, monitors and discharges the Investment Advisers who manage X's portfolio and the Administrative Committee which oversees other administrative matters such as supervision of the staff and operations.

One solution to the problem which was considered would be to reorganize X into three or four new foundations having more cohesive memberships pursuant to Section 507(b)(2) of the Code. However, that alternative has been rejected thus far in favor of a less drastic and less expensive alternative; namely, an internal reorganization of the existing foundation (X) which would provide the members with more influence in the grant-making area and in corporate governance. Members will be given the opportunity to sponsor grants. The aggregate amount to be distributed in grants for each year will be notionally allocated to the members on a per capita basis and each member will be entitled to recommend grant applicants in such amount. Those members who desire to have X make grants to charities who function in their local communities or to other charities which they favor will be free to recommend applicants for such purposes and those members who wish X to continue the practice of making grants in program areas of national and international significance or dealing with major public policy issues will also be free to recommend applicants for that purpose, either alone or in conjunction with other members who are similarly disposed.

Although it is anticipated that the grants proposed by members will be made in substantially all cases, the Board of Trustees will reserve the right to finally approve all such grants after review by the staff of the qualifications of the prospective grantees under section 501(c)(3) of the Code and the extent to which the proposed grants are subject to expenditure responsibility requirements of the Code. The Board of Trustees is expected to appoint a small grant committee to function between annual meetings of the Board to review and approve the recommended grants after completion of such staff review. The Board of Trustees will also reserve the right to reverse the new policies if they do not operate in practice as contemplated.

The composition of the Board of Trustees will be changed as part of the reorganization and it is anticipated that the Board will thereafter normally consist solely of members of X. In light of the differences which have arisen among the members as to corporate governance issues, members will be given the right to serve on the Board of Trustees if they wish. Although it would be possible to make membership in X coextensive with membership on the Board of Trustees, X does not wish to require members who desire to participate in grant-making to also serve on the Board and become "foundation managers" with the legal responsibilities imposed by law and under the Code on persons acting in that capacity if they are not otherwise inclined to serve as Trustees. X also desires to preserve the flexibility to elect qualified individuals to the Board without also making them members of X.

As a result of the reorganization, members are expected to become substantially more actively involved on a daily basis in X's charitable activities and to devote significantly more time to Foundation affairs as contrasted with the past where the principal function of the members in many years was to elect the Board of Trustees for the ensuing year and to vote on other matters submitted to the members by the Board of Trustees or pursuant to X's organizational documents. The members will not receive any compensation from X for such services or for any other services rendered to X in any capacity, irrespective of whether they also act as Trustees or officers of X.

The members will, however, incur expenses in the course of their greater activities on X's behalf such as meals and travel expenses to meet with prospective grantees or to review proposed projects for grant funding, local transportation, long distance telephone and fax charges, and similar items of expense which normally arise in the course of such activities. Members would be invited to attend one combined annual meeting of the Trustees and members per year where the grant making activities will be reviewed and revised, if appropriate, and the policies, budget, staffing and other items of business for the coming year will be proposed, discussed, formulated and approved. The members of X are widely dispersed throughout the United States and the size of the membership, coupled with the length of the expected agenda and the differing viewpoints represented, would make it impractical to hold such meeting by conference call. X would pay their expenses for attendance at such meeting and pay or reimburse the expenses they incur in the course of identifying suitable grant applicants.

X may also from time to time retain and pay consultants or other experts at the request of the members to review program areas or specific grants proposed by those members who wish to continue the prior grant-making practices since the staff will no longer be adequate to perform such function. None of the members of X will be retained for such purpose. As a matter of policy, X will impose a ceiling on the maximum amount of expenses for which a member may be responsible during any fiscal year of 8% of the amount of the grant funds which a member may sponsor for such year. Members will be reimbursed by X for their reasonable and legitimate grant making expenses incurred during any year to the extent such expenses do not exceed the 8% ceiling. The 8% limitation on expenses shall not apply to reasonable expenses incurred by members in their status as Trustees or officers in discharging their non-grant making duties as Trustees or officers, nor to the expenses of members in attending the annual meeting. The expenses of the members, along with the other items of revenue and expense, will be subject to scrutiny by X's independent public accountants who prepare and sign its annual return on Form 990.

Other aspects of the reorganization are expected to result in a decline in expenses once the transition to the new policies has been completed which is expected to take approximately two years. For example, as a result of the greater involvement of the members in grant-making, X is no longer expected to require two highly experienced and professional members of the staff to review program areas and to attract and review qualified applicants and provide the other required managerial duties. While they will be retained for a period to oversee implementation of the reorganization, they will eventually be replaced by one lower level program officer whose principal responsibility in the grant-making area will be to review the qualifications of grantees sponsored by the members from the standpoint of section 501(c)(3) of the Code and to document and administer grants which are subject to the expenditure responsibility requirements of the Code or other terms and conditions. Although meetings of the smaller committees of the Board may be held more frequently, meetings of the Board of Trustees will be reduced from three per year to one combined

annual meeting of the Trustees and members. Consideration will also be given to moving to smaller offices once the existing lease has expired.

Although X is effecting the proposed reorganization to address the concerns of the membership which have been described and not to reduce the total administrative expenses, and X is not representing as a condition to the requested ruling that the overall administrative expenses of X will decline once the transition has been completed, that in fact is the expectation of X. In any event, the total administrative expenses of operating X are expected to be significantly less than the aggregate expenses of creating, staffing and operating the three or four foundations which would result from a section 507(b)(2) reorganization if that alternative had been adopted to address such concerns.

Section 4941(a) of the Code imposes a tax on each act of self-dealing between a disqualified person and a private foundation.

Section 4941(d)(1)(D) of the Code provides that the term "self-dealing" means any direct or indirect payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person.

Section 4941(d)(2)(C) of the Code provides that the furnishing of goods, services, or facilities by a disqualified person to a private foundation shall not be an act of self-dealing if the furnishing is without charge and if the goods, services, or facilities so furnished are used exclusively for purposes specified in section 501(c)(3).

Section 4941(d)(2)(E) of the Code provides that except in the case of a Government official, the payment of compensation (and the payment or reimbursement of expenses) by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation shall not be an act of self-dealing if the compensation (or payment or reimbursement) is not excessive.

Section 53.4941(d)-(3)(c) of the Foundation and Similar Excise Taxes Regulations provides that the exception of section 4941(d)(2)(E) applies without regard to whether the person who receives the compensation (or payment or reimbursement of expenses) is an individual. Example 2 of subsection (2) of these regulations, provides that a manager of a private foundation who owns an investment counselling business, and who, in acting in his capacity as an investment counsellor, manages a private foundation's investment portfolio for which he receives a fee, will not be engaged in an act of self-dealing where the fee is determined not to be excessive.

Section 53.4941(d)-3(c)(1) of the regulations provides in relevant part that for the determination of whether compensation is excessive, see section 1.162-7 of this chapter (Income Tax Regulations). This paragraph applies without regard to whether the person who receives the compensation (or payment or reimbursement) is an individual.

Section 53.4945-6(b)(2) of the regulations provides that any expenditures for unreasonable administrative expenses, including compensation, consultant fees, and other fees for services rendered, will ordinarily be taxable expenditures under section 4945(d)(5) unless the foundation can demonstrate that such expenses were paid or incurred in the good faith belief that they were

reasonable and that the payment or incurrence of such expenses in such amounts was consistent with ordinary business care and prudence.

Section 53.4946-1(f)(1) of the regulations provides, in relevant part, that for purposes of Chapter 42 and the regulations thereunder, the term "foundation manager" means--

- (i) an officer, director, or trustee of a foundation (or a person having powers or responsibilities similar to those of officers, directors, or trustees of the foundation), and
- (ii) with respect to any act or failure to act, any employee of the foundation having final authority or responsibility (either officially or effectively) with respect to such act or failure to act.

Section 53.4946-1(f)(2) of the regulations provides that for purposes of subparagraph (1)(i) of this paragraph, a person shall be considered an officer of a foundation if-

- (i) He is specifically so designated under the certificate of incorporation, bylaws, or other constitutive documents of the foundation; or
- (ii) He regularly exercises general authority to make administrative or policy decisions on behalf of the foundation.

In John W. Madden, Jr. v. Commissioner, 74 TCM 440; T.C. Memo 1997-395, one of the questions before the court was whether general maintenance, janitorial, and custodial services provided by a disqualified person to the private foundation museum were of the same character as those services discussed in the examples in the regulations and could therefore be deemed to be "personal services". After citing the legislative history of section 4941, the court noted that it was congressional intent that any exceptions to the self-dealing transaction rules should be construed narrowly. The Court concluded that the general maintenance, janitorial, and custodial services were different in nature from the professional and managerial services in the examples in the regulations and therefore would not meet the definition of personal services.

The services to be performed by X's members, selecting grant program areas and grantees, are services of the same character as the professional and managerial type services discussed in the examples of section 53.4941(d)-3(c)(2) of the regulations.

It is the Board of Trustees's responsibility to ensure an efficient means of controlling and managing X's assets and affairs. Reorganizing its internal structure to address the concerns of the members will enhance X's ability to carry out its exempt purposes consistent with preserving X and its existing membership intact and avoiding a divisive and more expensive reorganization.

After the proposed reorganization, X's methods of operation as contemplated by the reorganization represents a significant departure from past operations, by giving members a much more active role in X's management. However, X will continue to carry out its charitable program as a grant-making foundation with ultimate responsibility for X's management in the Board of Trustees.

Based on the information submitted and the representations made therein, we rule as follows:

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A. The activities of the members involved in selecting grant program areas and grantees and participating in other management activities as described, constitute "personal services" within the meaning of the exception contained in section 4941(d)(2)(E) of the Code.

B. The payment or reimbursement by X of the expenses of the members of X for their personal services in selecting grant program areas and grantees and actively participating in X's other management activities, including the expenses of attending one annual meeting per year, are reasonable and necessary to carry out the exempt purposes of X within the meaning of the exception contained in section 4941(d)(2)(E) of the Code provided such payment or reimbursement is not excessive.

This ruling is directed only to the organization that requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Because this ruling may help resolve future questions about your exempt status, you should keep a copy in your permanent records.

Sincerely,

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Robert C. Harper, Jr.
Chief, Exempt Organizations
Technical Branch 3